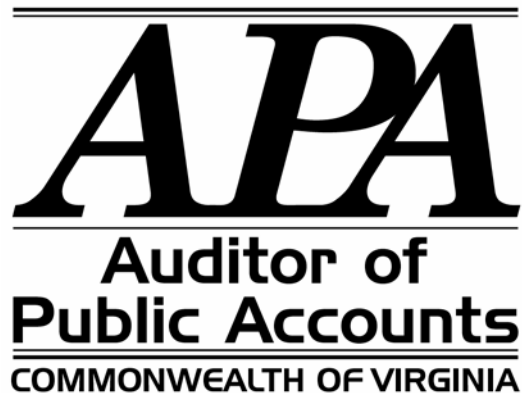


UNIVERSITY OF VIRGINIA MEDICAL CENTER

**REPORT ON AUDIT
FOR THE YEAR ENDED
JUNE 30, 2006**



AUDIT SUMMARY

Our audit of the University of Virginia Medical Center, for the year ended June 30, 2006, found:

- the financial statements are presented fairly, in all material respects;
- no internal control matters that we consider to be material weaknesses; and
- no instances of non-compliance or other matters required to be reported.

- TABLE OF CONTENTS -

Pages

MANAGEMENT'S DISCUSSION AND ANALYSIS

FINANCIAL STATEMENTS:

Statement of Net Assets

Statement of Revenues, Expenses, and Changes in Net Assets

Statement of Cash Flows

Notes to Financial Statements

INDEPENDENT AUDITOR'S REPORT

UNIVERSITY OFFICIALS

MANAGEMENT'S DISCUSSION AND ANALYSIS

(Unaudited)

The following discussion and analysis provides an overview of the financial position and activities of the University of Virginia's Medical Center (Medical Center) for the year ended June 30, 2006, with comparative information for the year ended June 30, 2005. This discussion has been prepared by management and should be read in conjunction with the financial statements and the notes thereto, which follow this section.

The Medical Center is one of the three operating divisions of the University of Virginia (University). The Vice President and Chief Executive Officer of the Medical Center provides overall leadership and management of the Medical Center. The Medical Center is an integrated network of primary and specialty care services ranging from wellness programs and routine checkups to the most technologically advanced care. The hub of the Medical Center is a 574-bed hospital with a state designated Level 1 trauma center located on the Charlottesville grounds. In addition, primary and specialty care is provided at clinic locations throughout central Virginia communities.

Financial Highlights

Operating Results

	<u>2006</u>	<u>2005</u>
Operating revenues	<u>\$857.0</u>	<u>\$810.3</u>
Operating income	\$ 42.8	\$ 47.5
Non-operating income and other	<u>21.1</u>	<u>16.0</u>
Increase in net assets	<u>\$ 63.9</u>	<u>\$ 63.5</u>
Cash and investments	\$630.6	\$520.0
Other assets	470.1	471.0
Liabilities	<u>(368.2)</u>	<u>(322.5)</u>
Net assets	<u>\$732.5</u>	<u>\$668.5</u>

*In millions

The Medical Center's financial results for fiscal year 2006 compare favorably to fiscal year 2005. Although operating income decreased by \$4.7 million this decline was more than offset by a \$5.1 increase in non-operating revenue. As a result, the increase in net assets was \$.4 million greater in 2006 as compared to 2005. Increased demand for both inpatient and outpatient services, and increased charge rates resulted in an increase in operating revenues of \$46.7 million (5.8 percent) while operating costs increased by \$51.4 million (6.7 percent). Non-operating revenues of \$21.1 million exceed last year's amount by 31.9 percent. The result of these changes was an increase of \$63.9 million to net assets.

Financial Statements

The Medical Center's financial report includes three financial statements: the Statement of Net Assets, the Statement of Revenues, Expenses, and Changes in Net Assets, and the Statement of Cash Flows. These financial statements are prepared in accordance with the Governmental Accounting Standards Board (GASB) Statement 34, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments*; GASB Statement 35, *Basic Financial Statements and Management's Discussion and Analysis of Public Colleges and Universities* and with the Financial Accounting Standards Board requirements for Health Care Organizations.

Statement of Net Assets

The Statement of Net Assets presents the financial position of the Medical Center at the end of the fiscal year, including all assets and liabilities of the Medical Center. Net assets are the difference between total assets and total liabilities and are one of the indicators used to evaluate the current financial condition of the Medical Center. In contrast, the change in net assets indicates whether the overall financial condition improved or worsened during the year. Shown below is a summary of the Medical Center's Statement of Net Assets.

<u>Statement of Net Assets</u>				
As of June 30, 2006 and 2005				
	<u>2006</u>	<u>2005</u>	<u>Increase/(Decrease)</u>	
Assets				
Current assets	\$ 331.8	\$285.8	\$ 46.0	16.1%
Capital assets	351.7	330.6	21.1	6.4%
Other non-current assets	<u>417.2</u>	<u>374.5</u>	<u>42.7</u>	<u>11.4%</u>
Total assets	<u>1,100.7</u>	<u>990.9</u>	<u>109.8</u>	<u>11.1%</u>
Liabilities				
Current liabilities	212.1	190.0	22.1	11.6%
Non-current liabilities	<u>156.1</u>	<u>132.4</u>	<u>23.7</u>	<u>17.9%</u>
Total liabilities	<u>368.2</u>	<u>322.4</u>	<u>45.8</u>	<u>14.2%</u>
Net Assets				
Invested in capital assets, net of related debt	210.2	197.9	12.3	6.2%
Restricted for				
Non-expendable	53.1	53.1	-	-
Expendable	34.4	26.0	8.4	32.3%
Unrestricted	<u>434.8</u>	<u>391.5</u>	<u>43.3</u>	<u>11.0%</u>
Total net assets	<u>\$ 732.5</u>	<u>\$668.5</u>	<u>\$ 64.0</u>	<u>9.6%</u>

*In millions

During fiscal year 2006, the Medical Center's financial position improved. Net assets increased by \$63.9 million as a result of the Medical Center's positive operating performance. The increase of \$46.0 million in current assets includes a \$19.5 million increase in securities lending transactions executed by the State Treasurer's Office. These amounts are offset by a security lending obligation increase in the current liabilities. The remainder of the cash increase was derived from current operations. Non-current assets increased by \$63.7 million. The largest item contributing to this was an increase of \$21.1 million in the value of capital assets. Shown below are the major capital additions made in the past two fiscal years.

The largest component of the increase in current liabilities was a \$19.5 million increase to obligations under security lending transaction as discussed above. The net increase to non-current liabilities of \$28.4 resulted primarily from the issuance of \$37.4 million of bonded indebtedness.

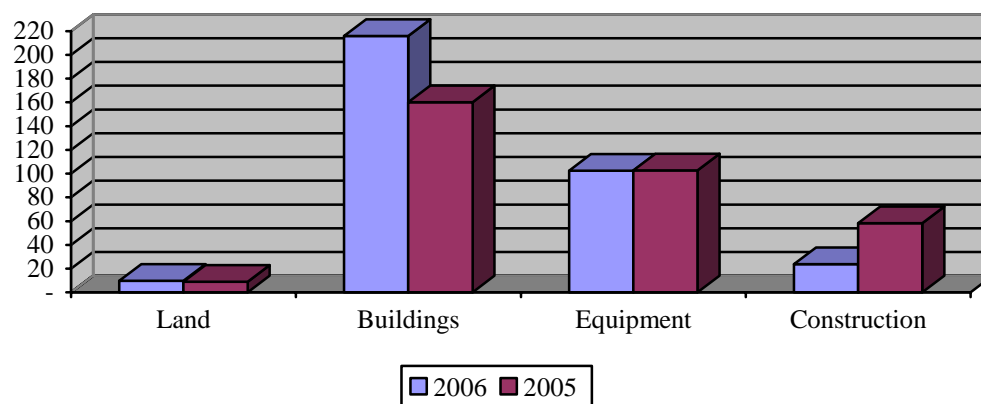
Major Capital Additions

	<u>2006</u>	<u>2005</u>
University hospital expansion	\$24.6	\$28.7
Outpatient Surgery Center land and building	7.4	-
Radiology and imaging systems	6.6	1.6
Information systems and related hardware	6.4	11.9
Other health system renovations	6.4	2.0
Primary Care Building renovation	3.4	-
Core Lab Building and equipment	0.9	7.2
Jefferson Park Avenue renovations	-	2.6
Mobile operating rooms and equipment	-	2.7
Infusion and syringe pumps	-	2.2
Clinic renovations	-	2.1
Outpatient surgery center equipment	-	1.7
Lynchburg dialysis equipment	-	1.3
Total	<u>\$55.7</u>	<u>\$64.0</u>

*In millions

Components of the Medical Center's capital assets are shown below:

Capital Assets



* In millions

Statements of Revenues, Expenses, and Changes in Net Assets

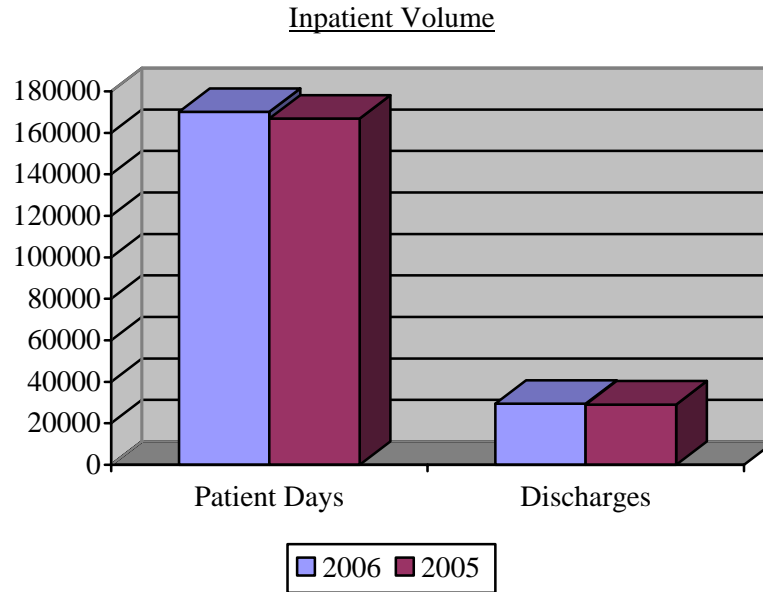
Changes in total net assets as presented in the Statements of Net Assets are based on activity shown in the Statements of Revenues, Expenses, and Changes in Net Assets. The purpose of these statements is to present the Medical Center's operating and non-operating revenues, and expenses and any other revenues, expenses, gains, and losses. A summarized comparison of revenues, expenses, and other changes in net assets for the years ended June 30, 2006 and 2005 is as follows:

Statements of Revenues, Expenses, and Changes in Net Assets For the Years Ended June 30, 2006 and 2005

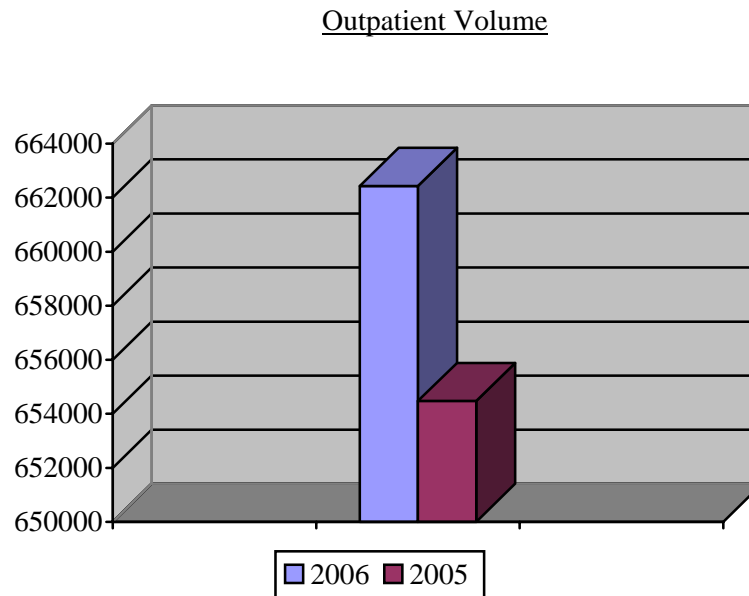
	<u>2006</u>	<u>2005</u>	<u>Increase/(Decrease)</u>	
Operating revenue:				
Net patient service revenue	\$819.5	\$780.2	\$39.3	5.0%
University allocations	16.0	10.7	5.4	50.3%
Other	<u>21.5</u>	<u>19.4</u>	<u>2.1</u>	<u>10.7%</u>
Total operating revenue	857.0	810.3	46.8	5.8%
Operating expenses:				
Salaries and benefits	352.2	334.8	17.4	5.2%
Other	<u>462.0</u>	<u>428.0</u>	<u>34.0</u>	<u>8.0%</u>
Total operating expenses	<u>814.2</u>	<u>762.8</u>	<u>51.4</u>	<u>6.7%</u>
Operating income	42.8	47.4	(4.5)	(9.8%)
Non-operating revenue	<u>21.2</u>	<u>16.0</u>	<u>5.1</u>	<u>31.9%</u>
Increase in net assets	64.0	63.4	0.6	0.9%
Net assets-beginning of year	<u>668.5</u>	<u>605.1</u>	<u>63.4</u>	<u>10.5%</u>
Net assets-end of year	<u>\$732.5</u>	<u>\$668.5</u>	<u>\$64.0</u>	<u>9.6%</u>

Operating Revenue

Total operating revenue for the fiscal year 2006 was 5.8 percent above the prior year. This increase resulted from patient volume increases and a rate increase. As shown by the graph below, both inpatient discharges and inpatient days were up slightly from the prior year. Although discharges increased by 1.3 percent over the prior year, patient days increased by 1.9 percent as a result of a slight increase in the average length of stay. The increase in average length of stay is attributable to the increase in surgical cases. Thoracic cardiovascular surgery (TCV), transplant surgery, neurosurgery, general surgery, and orthopedic surgery admissions are all above last year. TCV and transplant cases had the most significant increases, with admissions for TCV 17.7 percent higher than last fiscal year, and the number of solid organ transplants 35.3 percent higher than last year.



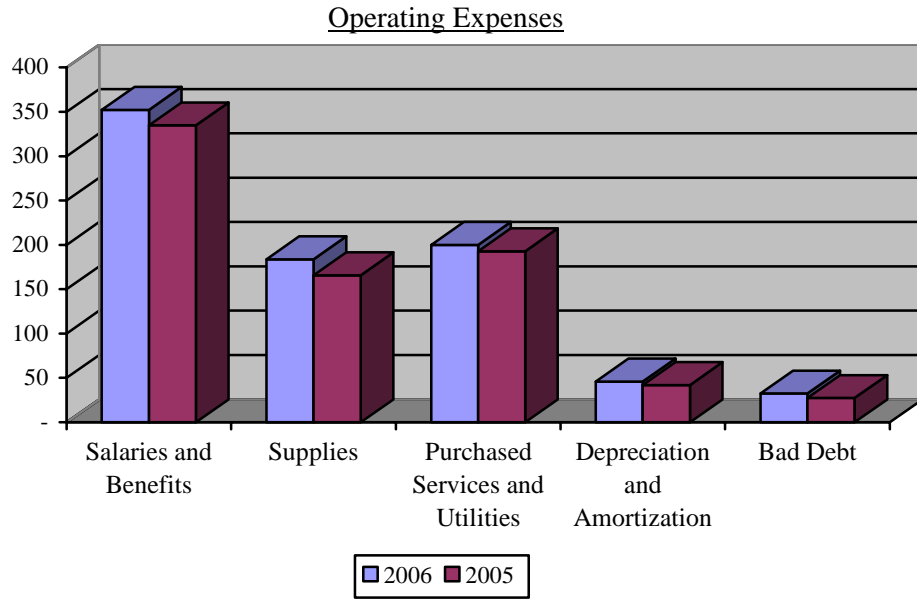
There was also a 1.2 percent growth in outpatient visits over the prior year, including Emergency Department visits.



Operating Expenses

As a result, of growth in patient volumes and inflation, operating expenses increased by 6.7 percent over the prior year. The following items contributed to this growth:

- Compensation cost increased by 5.2 percent, which is in line with salary increases and growth in volume.
- Supply expense experienced the most significant operating costs increase. This was the result of volume increases and in the increase in surgical cases as discussed above. Also, average case mix index, a measure of resource consumption, increased from 1.75 to 1.83.



*In millions

Statement of Cash Flows

The statement of cash flows provides additional information about the Medical Center's financial results by reporting the major sources and uses of cash. A comparative summary of the statement of cash flows for the years ended June 30, 2006 and 2005 is as follows:

<u>Statement of Cash Flows</u>				
For the Years Ended June 30, 2006 and 2005				
	<u>2006</u>	<u>2005</u>	<u>Increase/(Decrease)</u>	
Cash flows from operating activities	\$116.3	\$130.2	\$(13.9)	\$ (10.7%)
Cash flows from non-capital financing activities	(2.5)	1.7	(4.2)	(249.0%)
Cash flows from capital and related financing activities	(49.6)	(85.9)	36.3	42.3%
Cash flows from investing activities	<u>(2.9)</u>	<u>2.4</u>	<u>(5.3)</u>	<u>(220.3%)</u>
Net increase in cash and cash equivalents	61.3	48.4	12.9	26.9%
Cash and cash equivalents - beginning of the year	<u>149.2</u>	<u>100.8</u>	<u>48.4</u>	<u>48.0%</u>
Cash and cash equivalents - end of the year	<u>\$210.5</u>	<u>\$149.2</u>	<u>\$61.3</u>	<u>41.1%</u>

*In millions

The cash generated from operating activities decreased by 10.7 percent from 2005 to 2006 primarily as a result of increased payments to employees and suppliers. Operating cash received for patient services increased by 7.2 percent as a result of increase service volume and improved collections from patients accounts receivable. Although net patient revenue increased by \$39.3 million in 2006, net accounts receivable decreased by \$23.9 million during this same period. Cash required for capital and related financing required \$36.3 million less cash than the previous year because \$37.4 million in bond proceeds were received from a bond issue for the Hospital Expansion project as discussed below. This amount was more than offset by the \$69.2 million spent for capital assets in 2006. Cash provided from investing activities decreased by \$5.3 million. Although there was a \$5.1 million increase in investment income, total cash provided by investment activities declined from last year because an increase in investments required \$17.0 million of cash.

Economic Factors Affecting the Future

The Medical Center continues to improve and upgrade its inpatient hospital services. During fiscal year 2003, the Medical Center began a major expansion of its University Hospital facility that will cost \$95.2 million including the costs of equipment. This project was undertaken to expand and improve facilities for Heart, Perioperative, and Interventional Radiology services. Included in the project are an addition of five operating rooms and complete reconstruction of 19 existing operating rooms, expansion and reconstruction of Heart Center diagnostic, interventional, and clinic facilities, relocation and expansion of Interventional Radiology, and the reorganization and modernization of hospital based clinical laboratory functions. To ensure that the new facilities will have the capability to provide the most advanced care for patients well into the future, management has committed to a plan for making a major investment in the latest technology for the services located in the newly constructed spaces. The addition was completed in July 2004 and the remainder of the renovations should be completed by June 2007.

The Medical Center is also increasing its capacity for providing outpatient services. A new Clinical Cancer Center will be constructed on its main campus with construction starting in the 2008 fiscal year. The new center will consolidate the cancer clinics in one location, enhance the layout and amenities of the clinics, and allow for new therapeutic equipment. The Medical Center plans to invest \$101.7 million in this project including related utilities and parking facilities. The Commonwealth has appropriated \$25 million in General Funds for the project and the remainder of the cost will be financed by a combination of Medical Center funds, bonded indebtedness, and private philanthropy.

The Center for Medicare Services (CMS) issued proposed rules for public comment, which would materially impact Medicare payments to all hospitals. These new rules will be phased in over a three-year period. The Medical Center, as well as industry groups, is analyzing the impact of the final rules on payments we receive from CMS for treating Medicare patients but as of this date, the effect is not known.

FINANCIAL STATEMENTS

UNIVERSITY OF VIRGINIA MEDICAL CENTER
STATEMENT OF NET ASSETS
As of June 30, 2006
With Comparative Amounts as of June 30, 2005

	2006	2005
A S S E T S		
Current assets		
Cash and cash equivalents (Note 2)	\$ 178,835,424	\$ 130,634,546
Cash and cash equivalents - securities lending	24,895,527	5,267,427
Short term investments - securities lending	24,636,981	24,788,628
Accounts receivable, net of estimated uncollectibles of \$145,845,871 at June 30, 2006	79,339,057	103,275,979
Due from University of Virginia	4,573,840	4,648,894
Inventories and prepaid expenses	19,473,170	17,192,476
Notes receivable	13,131	18,490
Total current assets	331,767,130	285,826,440
Noncurrent assets		
Cash and cash equivalents restricted (Note 2)	9,283,699	8,584,012
Prepaid heating plant costs	185,310	-
Investments in pooled endowment funds (Note 2)	124,044,694	111,912,132
Goodwill (Note 3)	14,185,686	14,658,077
Investments (Note 2)	6,751,479	6,557,728
Investments in affiliated companies (Note 4)	7,354,670	6,436,699
Land (Note 5)	8,190,246	6,975,246
Construction-in-progress (Note 5)	23,851,624	58,475,708
Depreciable land improvements, buildings, and equipment, less accumulated depreciation of \$388,738,320 at June 30, 2006 (Note 5)	319,692,383	265,185,798
Deferred bond discount and issue costs, net of amortization of \$170,194 at June 30, 2006	581,232	614,405
Assets whose use is limited		
Cash and cash equivalents (Note 2)	22,421,228	9,943,948
Investments (Note 2)	232,344,744	215,821,776
Total noncurrent assets	768,886,995	705,165,529
Total assets	1,100,654,125	990,991,969
L I A B I L I T I E S		
Current liabilities		
Accounts payable and accrued expenses (Note 7)	96,097,204	105,488,314
Obligations under security lending (Note 2)	49,532,508	30,056,055
Due to third-party payors	49,956,124	38,673,460
Current installments of long-term debt (Note 8)	8,265,292	9,029,999
Grants payable - current portion	8,106,874	6,671,861
Bond premium - current amortization	111,954	109,847
Total current liabilities	212,069,956	190,029,536
Long-term liabilities		
Long-term debt (Note 8)	149,380,915	124,798,263
Grants payable - noncurrent portion	4,333,334	5,000,000
Bond premium, net of amortization	647,948	759,902
Non-controlling interest in subsidiary	1,755,940	1,861,660
Total long-term liabilities	156,118,137	132,419,825
Total liabilities	368,188,093	322,449,361

NET ASSETS

Invested in capital assets, net of related debt	210,214,172	197,883,662
Restricted for		
Nonexpendable	53,099,192	53,099,192
Expendable	34,337,981	25,994,260
Unrestricted	434,814,687	391,565,494
	<hr/>	
Total net assets	\$ 732,466,032	\$ 668,542,608
	<hr/>	

The accompanying Notes to Financial Statements are an integral part of this statement.

UNIVERSITY OF VIRGINIA MEDICAL CENTER
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
As of June 30, 2006
With Comparative Amounts as of June 30, 2005

	2006	2005
Operating revenue		
Net patient service revenue (Note 10)	\$ 819,501,040	\$ 780,197,093
University allocations (Note 11)	16,036,687	10,671,490
Other	21,479,825	19,398,970
Total operating revenue	857,017,552	810,267,553
Operating expenses		
Salaries and wages	282,904,809	268,241,061
Fringe benefits	69,279,721	66,586,617
Supplies	183,721,915	165,845,399
Purchased services and other expenses	185,561,337	179,722,048
Utilities	14,485,006	13,015,780
Provision for depreciation and amortization	45,962,412	42,008,125
Provision for bad debts	32,285,536	27,389,200
Total operating expenses	814,200,736	762,808,230
Income from operations	42,816,816	47,459,323
Nonoperating revenue/(expenses)		
Gifts	771,447	2,786,304
Investment income	20,374,317	14,783,415
Net increase in the fair value of investments	7,388,831	7,144,077
Net gain from investments in affiliated companies (Note 4)	1,196,837	2,445,331
Noncontrolling interest in subsidiary income	(2,019,894)	(1,591,856)
Interest expense	(4,712,274)	(4,815,973)
Loss on disposal of fixed assets	(1,892,656)	(184,995)
Gain sharing with the School of Medicine	-	(4,408,929)
Other	-	(140,000)
Net nonoperating revenues	21,106,608	16,017,374
Increase in net assets	63,923,424	63,476,697
Net assets - beginning of year	668,542,608	605,065,911
Net assets - end of year	\$ 732,466,032	\$ 668,542,608

The accompanying Notes to Financial Statements are an integral part of this statement.

UNIVERSITY OF VIRGINIA MEDICAL CENTER
STATEMENT OF CASH FLOWS
As of June 30, 2006
With Comparative Amounts as of June 30, 2005

	2 0 0 6	2 0 0 5
Cash flows from operating activities		
Receipts from patients and third-parties	\$ 827,614,562	\$ 772,360,983
Receipts from other revenue	20,138,787	22,688,847
Payments to employees	(364,501,498)	(333,889,035)
Payments to suppliers	(352,464,488)	(317,951,281)
Payment for utilities	(14,485,006)	(13,015,780)
Net cash provided by operating activities	116,302,357	130,193,734
Cash flows from noncapital financing activities:		
Payments on grants	(3,231,654)	(1,135,427)
Gifts	771,447	2,786,304
Net cash provided/(used) by non-capital financing activities	(2,460,207)	1,650,877
Cash flows from capital and related financing activities		
Purchase of capital assets	(69,249,861)	(77,368,043)
Principal paid on capital debt	(13,045,231)	(8,170,651)
Interest paid on capital debt	(4,824,332)	(4,815,973)
Proceeds from incurring loan from the University	37,423,897	4,102,411
Proceeds from sale of capital assets	126,703	365,966
Net cash used by capital and related financing activities	(49,568,824)	(85,886,290)
Cash flows from investing activities:		
Interest on investments	16,197,151	11,057,046
Purchase of investments	(183,284,773)	(88,868,214)
Proceeds from sale of investments	166,322,954	94,867,070
Other	-	1,346,637
Purchase of affiliate entities	-	(14,473,587)
Transfer to affiliate	(5,000)	(58,800)
Payment to affiliate	(2,125,814)	(1,463,400)
Net cash provided by investing activities	(2,895,482)	2,406,752
Net increase in cash and cash equivalents	61,377,846	48,365,073
Cash and cash equivalents - beginning of the year	149,162,506	100,797,433
Cash and cash equivalents - end of the year	\$ 210,540,352	\$ 149,162,506

RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED
BY OPERATING ACTIVITIES

Operating income	\$ 42,816,816	\$ 47,459,323
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation and amortization	45,962,412	42,008,125
Change in assets and liabilities		
Accounts receivable	35,055,399	23,662,586
Inventories and prepaid expenses	(2,280,694)	377,420
Accounts payable and accrued expenses	(5,251,576)	16,686,280
Net cash provided by operating activities	<u>\$ 116,302,357</u>	<u>\$ 130,193,734</u>

The accompanying Notes to Financial Statements are an integral part of this statement.

NOTES TO FINANCIAL STATEMENTS

UNIVERSITY OF VIRGINIA MEDICAL CENTER

NOTES TO FINANCIAL STATEMENTS

AS OF JUNE 30, 2006

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Organization and Mission

The Medical Center is a division of the University. The Medical Center's mission is to enrich the quality of human life by improvement of health, advancement of medical and scientific knowledge, and by creation of an environment for professional preparation of individuals dedicated to healthcare service. Only those activities directly associated with the furtherance of this mission are considered to be operating activities. Other activities that result in gains or losses unrelated to the Medical Center's primary mission are considered to be non-operating.

A separate report is prepared for the Commonwealth that includes all agencies, boards, commissions, and authorities over which the Commonwealth exercises or has the ability to exercise oversight authority. The University is a component unit of the Commonwealth and is included in the basic financial statements of the Commonwealth.

B. Basis of Accounting

The Medical Center has adopted the accrual basis of accounting in accordance with Generally Accepted Accounting Principles (GAAP) as prescribed by the Governmental Accounting Standards Board (GASB) and the Financial Accounting Standards Board (FASB) for providers of healthcare services.

Pursuant to GASB Statement 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the Medical Center has elected to apply the provisions of all relevant pronouncements of FASB, including those issued after November 30, 1989.

The financial statements have been prepared in accordance with GASB Statement 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, and GASB Statement 35, *Basic Financial Statements and Management's Discussion and Analysis of Public College and Universities*.

C. Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

D. Subsidiary and Affiliated Companies

The consolidated financial statements include the accounts of controlled subsidiary companies where ownership is greater than 50 percent. Investments in affiliates in which the Medical Center has a substantial interest (approximately 20 to 50 percent) or for which the Medical Center exercises significant influence, but not control, over policy decisions are accounted for by the equity method.

E. Net Patient Service Revenue

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payers, and others for services rendered. Net patient service revenue also includes funds from the Commonwealth's Department of Medical Assistance Services for disproportionate share and indirect medical education payments and funds from third-party payers for estimated retroactive adjustments under reimbursement agreements. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

F. Indigent Care

The Medical Center accepts all patients regardless of their ability to pay. A patient is classified as indigent by reference to established Commonwealth policies. The criteria for identifying indigent patients are based on asset and income guidelines that are updated annually in accordance with the federal poverty income guidelines as provided by the federal Office of Management and Budget. Because the Medical Center does not pursue collection of amounts determined to qualify as indigent care, they are not reported as revenue.

G. Receivables From Third Parties and Contractual Adjustments

A significant portion of the Medical Center's services is rendered to patients covered by Medicare, Medicaid, or other third-party payers. The Medical Center entered into contractual agreements with these third parties to accept payment for services in amounts less than scheduled charges.

Certain annual settlements of amounts due for patient services covered by third parties are determined through cost reports that are subject to audit and retroactive adjustment by the third parties. Provisions for possible adjustments of cost reports have been estimated and reflected in the accompanying financial statements. Since the determination of cost reimbursement settlements of amounts earned in prior years has been based on reasonable estimation, the difference in any year between the originally estimated amount and the final determination is reported in the year of determination.

H. Cash, Cash Equivalents, and Investments

Cash and cash equivalents include cash and all highly liquid investments with maturity of three months or less when purchased.

Donated investments are reported at the fair market value at the date of receipt. The major portion of the investments of the Medical Center's endowment funds is pooled under the University of Virginia Growth and Income Fund, the general endowment pool for the University. Annually, endowment earnings on the consolidated endowment pool are distributed to the participating funds based on the participating share of each fund in the pool.

Investments are carried at fair value as determined by quoted market prices. Unrealized appreciation or depreciation of investments is included in the current period net earnings. All investment income, including changes in the fair value of investments (unrealized gains and losses), is reported as non-operating revenue in the Statement of Revenues, Expenses, and Changes in Net Assets.

Investments in affiliated companies are reported using the equity method of accounting.

I. Inventories

Inventories are valued at the lower of cost, generally determined on the weighted average method, or market and consist primarily of expendable supplies held for consumption.

J. Property, Plant, and Equipment

Property, plant, and equipment are stated at cost, or if donated, at fair market value at the date of donation. The Medical Center capitalizes expenditures for equipment costing \$2,000 or more and having a useful life of two years or greater in accordance with the *Medicare Reimbursement Manual*.

Depreciation on property, plant, and equipment, excluding land and construction-in-progress, is computed over the estimated useful lives of the assets using the straight-line method. The general range of estimated useful lives is 10 to 40 years for buildings and fixtures and 3 to 20 years for equipment.

The Medical Center utilizes the half-year convention for recognizing depreciation expense related to equipment, both fixed and moveable. A half-year of depreciation is recognized on all equipment in the fiscal year of acquisition. Likewise, a half-year of depreciation is recognized in the fiscal year at the end of the equipment's useful life. Depreciation on buildings is recognized from the date that the asset is placed in service to the date on which it is retired.

K. Deferred Bond Issue Costs

Deferred bond issue costs are amortized over the remaining life of the bonds.

L. Accrued Leave

The amount of leave earned, but not taken by salaried employees is recorded as a liability on the Statement of Net Assets. The amount reflects, as of June 30, 2006, all earned leave not taken and the amount payable under the catastrophic leave pay-out policy upon termination, which is the lesser of 25 percent of sick leave not taken or \$5,000 per employee with five or more years of service. The liability is based on the probability that an employee with less than five years of service will eventually become vested and has a right to receive payment for sick leave benefits. The applicable share of employer-related taxes payable on the eventual termination payments is also included

M. Reclassifications

Certain amounts from prior year statements have been reclassified to conform to current year presentation.

2. CREDIT RISK UNDERLYING CASH, CASH EQUIVALENTS AND INVESTMENTS

Cash, Cash Equivalents and Investments:

GASB Statement 40, *Deposit and Investment Risk Disclosures*, effective for fiscal periods beginning after June 15, 2004, amends GASB Statement Number 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreement), and Reverse Repurchase Agreements*. GASB Statement 40 eliminates the custodial credit risk disclosures required for category 1 and 2 deposits and investments, but maintains disclosures for category 3. The following risk disclosures are required by GASB Statement 40:

Custodial Credit Risk (Category 3 deposits and investments) - The custodial credit risk for deposits is the risk that, in the event of the failure of a depository financial institution, a government will not be able to recover deposits or will not be able to recover collateral securities that are in the possession of an outside party. The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. The Medical Center has no category 3 deposits or investments for 2006.

Credit risk - The risk that an issuer or other counterparty to an investment will not fulfill its obligations. GASB Statement 40 requires the disclosure of the credit quality rating on any investments subject to credit risk.

Concentration of credit risk - The risk of loss attributed to the magnitude of a government's investment in a single issuer. GASB Statement 40 requires disclosure of any issuer with more than five percent of the Medical Center investments are in FHLB, FHLMC, FNMA, and the University of Virginia Growth and Income Fund. These investments represent 14 percent, 33 percent, 15 percent, and 38 percent, respectively, of total investments.

Interest rate risk - The risk that changes in interest rates will adversely affect the fair value of an investment. GASB Statement 40 requires disclosure of maturities for any investments subject to interest rate risk. The Medical Center does not have an interest rate risk policy.

Foreign currency risk - The risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit. The Medical Center has no foreign investments or deposits for 2006.

The following information is provided with respect to the risks associated with the Medical Center's cash, cash equivalents, and investments at June 30, 2006.

Cash and Cash Equivalents

Pursuant to Section 2.2-1800, et seq., Code of Virginia, all state funds of the Medical Center are maintained by the Treasurer of Virginia who is responsible for the collection, disbursement, custody, and investment of state funds. Cash deposits held by the Medical Center are maintained in accounts collateralized in accordance with the Virginia Security for Public Deposits Act, Section 2.2-4400, et seq., Code of Virginia. The Virginia Security for Public Deposits Act eliminates any custodial credit risk for Medical Center's deposits. Cash and Cash Equivalents represent cash with the treasurer, cash on hand, certificates of deposit, and temporary investments with original maturities of 90 days or less, and cash equivalents with the Virginia State Non-Arbitrage Program (SNAP). SNAP is an open-end management investment company registered with the Securities and Exchange Commission (SEC). Cash and Cash Equivalents reporting requirements are defined by GASB Statement 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities that Use Proprietary Fund Accounting*.

Additional disclosures required for cash equivalents under GASB Statement Number 40 are presented with the investments in the following tables.

Investments

The investment policy of the Medical Center is established by the Board of Visitors and monitored by the Board's Finance and Audit Committee. Authorized investments are set forth in the "Investment of Public Funds Act" of the Code of Virginia Sections 2.2-4500 through 2.2-4516. Authorized investments include U.S. Treasury and agency securities; corporate debt securities of domestic corporations, asset-backed securities, mortgage-backed securities, AAA rated obligations of foreign governments, bankers' acceptances and bank notes, negotiable certificates of deposit, repurchase agreements, and money market funds.

Investments fall into two groups: short and long-term. Short-term investments have an original maturity of over 90 days but less than or equal to one year. Long-term investments have an original maturity greater than one year.

Credit and Concentration of Credit Risks

	<u>Fair Value</u>	<u>Credit Rating</u>	<u>Concentration Risk Percent</u>
Cash equivalents			
U.S. government securities			
Short-term investment fund	\$ 22,421,228	AAA	
State non-arbitrage program			
Virginia College Building Authority 1999A pooled bond fund	460,630		
Other	1,456,509		
FHLB-Federal Home Bank D/N	<u>19,927,917</u>	P-1	
 Total cash equivalents	 <u>\$ 44,266,284</u>		
Investments			
U.S. government securities			
Federal Home Loan Bank	\$ 43,580,350	AAA	12%
Federal Home Bank Callable	4,943,750	AAA	2%
Federal Home Loan Mortgage Corporation	89,552,279	AAA	27%
Federal Home Loan Mortgage Corporation (5.41)	4,989,350	AAA	2%
Federal Home Loan Mortgage Corporation (Callable)	4,939,250	AAA	2%
Federal Home Loan Mortgage Corporation (Step note)	4,917,850	AAA	2%
Federal National Mortgage Association	29,573,450	AAA	8%
Federal National Mortgage Association-(8/22/06)	4,990,650	AAA	2%
Federal National Mortgage Association-Step Up	14,795,350	AAA	5%
University of Virginia Growth and Income Fund	<u>124,044,694</u>		38%
 Total investments	 <u>326,326,973</u>		
 Total cash equivalents and investments	 <u>\$370,593,257</u>		

Interest Rate Risk – Maturities

	<u>Less than 1 year</u>	<u>1-5 years</u>	<u>Total</u>
Investments			
U.S. government securities:			
Federal Home Loan Bank	\$ 38,614,700	\$ 4,965,650	\$ 43,580,350
Federal Home Loan Bank Callable		4,943,750	4,943,750
Federal Home Loan Mortgage Corporation	44,626,500	44,925,779	89,552,279
Federal Home Loan Mortgage Corporation (5.41)	4,989,350	-	4,989,350
Federal Home Loan Mortgage Corporation (Callable)	4,939,250	-	4,939,250
Federal Home Loan Mortgage Corporation (Step note)	4,917,850	-	4,917,850
Federal National Mortgage Association	9,867,200	19,706,250	29,573,450
Federal National Mortgage Association (8/22/06)	4,990,650	-	4,990,650
Federal National Mortgage Association-Step Up	14,795,350	-	14,795,350
University of Virginia Growth and Income Fund	<u>-</u>	<u>124,044,694</u>	<u>124,044,694</u>
 Total investments	 <u>\$127,740,850</u>	 <u>\$198,586,123</u>	 <u>\$326,326,973</u>

Securities Lending Transactions

Investments and cash equivalents held by the Treasurer of Virginia represent the Medical Center's allocated share of cash collateral received and reinvested and securities received for the State Treasury's securities lending program. Information related to the credit risk of these investments and the State Treasury's securities lending program is available on a statewide level in the Commonwealth of Virginia's Comprehensive Annual Financial Report (CAFR).

3. GOODWILL

In July 1994, the Medical Center and the University of Virginia Health Services Foundation (HSF) entered into a Memorandum of Agreement for the purpose of joint purchase and operation of a hyperbaric oxygen unit. The memorandum provided that HSF would own 67 percent interest and the Medical Center would own 33 percent. In December 2000, the Medical Center acquired from HSF its interest in the hyperbaric oxygen unit. Of the acquisition price, \$1,166,615 was recorded as goodwill for the purchase of the assets and is being amortized over five years. The amortization ended in November 2005.

In May 2000, the Medical Center acquired from Augusta Health Care, Inc., the kidney dialysis assets in a transaction accounted for as a purchase. Accordingly, \$987,188 was recorded as goodwill for the purchase of the assets and is being amortized over five years. An additional \$800,000 was recorded as goodwill for a non-competition agreement and is being amortized over its ten-year life.

In July 2004, the Medical Center purchased Virginia Ambulatory Surgery Center, (VASI), now known as Virginia Outpatient Surgery Center. As a result of the purchase, the Medical Center recorded \$6,980,198 of goodwill to be amortized over a period of 40 years.

In November 2004, the Medical Center purchased Amherst and Lynchburg renal facilities. As a result of the purchase, the Medical Center recorded goodwill of \$3,476,068 and \$4,017,321, respectively, for the Amherst and Lynchburg facilities. The goodwill is to be amortized over a period of 40 years.

4. AFFILIATED COMPANIES

University of Virginia Imaging, LLC

On March 26, 2002, the Medical Center entered into an agreement with Outpatient Imaging Affiliates of Virginia, LLC to establish University of Virginia Imaging, LLC (UVI). The limited liability corporation was formed to operate an outpatient diagnostic imaging center to help respond to the need for radiology services in the Charlottesville area.

The Medical Center currently operates an outpatient imaging department offering MRI, plain film radiography, fluoroscopy, and ultrasound in office space at the Fontaine Research Park. Although available to all Medical Center physicians, the site principally serves orthopedic physicians located at the Fontaine Research Park. UVI also provides services to outpatients from the Medical Center's primary and secondary service areas.

Since the Medical Center owns 80 percent of UVI, its financial activity is presented under the consolidation method.

Community Medicine, LLC

On November 14, 2000, the University established the Community Medicine University of Virginia, LLC (Community Medicine). Community Medicine was established as a limited liability corporation (LLC) under the laws of the Commonwealth to house physician practices. This model gives physicians an organizational structure that allows them the opportunity to practice independently in a virtual private practice environment with all the risks and gains associated with an independent model. As an LLC, which is a wholly owned subsidiary of the University, Community Medicine is considered a disregarded entity for tax purposes and its financial activity is accounted for under the consolidation method.

Community Medicine commenced operations on July 1, 2001 and as of July 1, 2003; the Medical Center's investment totaled \$1,560,000. During fiscal year 2004, the Medical Center made an additional investment of \$250,000, bringing the total investment to \$1,810,000.

Central Virginia Health Network, Inc.

In May 1995, the Medical Center joined the Central Virginia Health Network, Inc. (CVHN), a partnership of eight Richmond area hospitals. CVHN was formed to provide an efficient and coordinated continuum of care, with services ranging from acute hospital treatment to primary physician care and home health services.

The Medical Center originally paid \$100 for 10,000 shares of common stock and \$109,900 as additional paid-in capital. In addition, the Medical Center is obligated for monthly dues to CVHN of \$15,913. Complete financial statements can be obtained from the registered agent: Steven D. Gravely, Esq., Mezzullo and McCandlish, Post Office Box 796, Richmond, Virginia 23206.

University of Virginia / HEALTHSOUTH, LLC

The Medical Center entered into a joint venture with HEALTHSOUTH Corporation to establish an acute rehabilitation facility located at the Fontaine Research Park to provide patient services to the region. The Medical Center made a capital contribution of \$2,230,000 to the joint venture in May 1996, which represents a 50 percent interest. Complete financial statements can be obtained from the managing member: HEALTHSOUTH Corporation, 7700 East Parham Road, Richmond, Virginia 23294.

Valiance Health, LLC

In November 1997, the Medical Center became a participant with Rockingham Memorial Hospital and Augusta Health Care, Inc., in Valiance Health, LLC (Valiance), a joint venture integrating and coordinating the delivery of healthcare services in central and western Virginia. The Medical Center contributed \$100,000 in initial capital, which entitles it to a pro-rata distribution of any profits and losses of Valiance. In October 2003, the Medical Center contributed an additional \$400,000 in capital to Valiance, bringing the Medical Center's total investment to \$500,000.

University Health System Consortium (UHC)

In December 1986, the Medical Center became a member of the University Health System Consortium (UHC). Founded in 1984, UHC is an alliance of the clinical enterprises of academic health centers. While focusing on the clinical mission, UHC is mindful of and supports the research and education missions. The mission of the UHC is to advance knowledge, foster collaboration, and promote change to help members compete in their respective healthcare markets. In keeping with this mission, UHC helps members pool resources, create economies of scale, improve clinical and operating efficiencies, and influence the direction and delivery of healthcare. Accordingly, UHC is organized and operated on a cooperative basis for the benefit of its member health systems as patrons.

UHC is a not-for-profit organization. It is incorporated as a nonstock corporation and designated as a nonexempt cooperative, which is taxable under Subchapter T, section 1382-1388, of the Internal Revenue Code. As such, UHC's bylaws provide for distributions of patronage dividends to its patrons. This allocation is based on the value of business done with or for each patron by UHC. The Medical Center records the portion of the patronage dividends that were held by UHC as patronage equity.

As of June 30, 2006

	Common Stock and Equity <u>Contributions</u>	Share of Accumulated <u>Income/(loss)</u>	<u>Net Investment</u>
UVA Imaging, LLC	\$ 687,019	\$1,914,468	\$2,601,487
Community Medicine, LLC	1,810,000	(2,935,102)	(1,125,102)
Central Virginia Health Network, Inc.	232,500	(41,026)	191,474
HealthSouth, LLC	2,230,000	3,785,875	6,015,875
Valiance, LLC	500,000	34,635	534,635
University Health System Consortium	-	613,484	613,484

HealthCare Partners, Inc.

In May 1995, HealthCare Partners, Inc., a non-stock, non-profit corporation, was established to support networking, external business relationships with neighboring hospitals and physicians groups, and expansion of primary care activities. The Medical Center and the Health Services Foundation are the primary contributors to the funding of the corporation. The corporation is governed by a board of directors composed of Health Sciences Center staff, community members, and University Board of Visitors appointees.

5. PROPERTY, PLANT, AND EQUIPMENT

A summary of the property, plant, and equipment accounts and the related accumulated depreciation as of June 30, 2006, is presented as follows:

	<u>Beginning Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending Balance</u>
Property, plant, and equipment				
Land	\$ 6,975,246	\$ 1,215,000	\$ -	\$ 8,190,246
Land improvements	8,326,647	950	-	8,327,597
Building	368,247,119	71,800,778	478,961	439,568,937
Equipment - fixed	20,797,135	1,212,456	1,071,621	20,937,970
Equipment - movable	237,941,239	30,232,281	28,577,328	239,596,192
Construction-in-progress	<u>58,475,708</u>	<u>34,574,058</u>	<u>69,198,136</u>	<u>23,851,630</u>
Total property, plant, and equipment	<u>700,763,095</u>	<u>139,035,524</u>	<u>99,326,046</u>	<u>740,472,573</u>
Less: Accumulated depreciation				
Land improvements	6,455,940	180,639	-	6,636,579
Building	207,683,117	16,124,376	40,310	223,767,183
Equipment - fixed	15,484,948	723,129	394,753	15,813,324
Equipment - movable	<u>140,502,337</u>	<u>28,405,687</u>	<u>26,386,790</u>	<u>142,521,234</u>
Total accumulated depreciation	<u>370,126,343</u>	<u>45,433,831</u>	<u>26,821,853</u>	<u>388,738,320</u>
Net property, plant, and equipment	<u>\$330,636,752</u>	<u>\$ 93,601,694</u>	<u>\$75,504,192</u>	<u>\$351,734,254</u>

6. ASSETS HELD BY TRUSTEES

Assets held by trustees consist of assets whose use is limited under indenture agreements. The Series 1998B, 1999A, 2003A, 2003B, and 2006 bond resolutions require that deposits be made in a specific order to various accounts and funds held by the Treasurer of Virginia as follows:

- A. to the credit of the Interest Account on a monthly basis, the amount of interest due and payable on the first day of the succeeding month with respect to the bonds of each series then outstanding;
- B. to the credit of the Principal Account on an annual basis, the amount sufficient to pay maturing principal of all bonds on the next principal payment date;
- C. to the credit of the Sinking Fund Account, the amount sufficient to retire all bonds to be called by mandatory redemption on the next ensuing mandatory redemption date;
- D. to the credit of the Reserve Fund, the amount necessary to fund the Reserve Account Requirement, as defined by the bond resolution;

- E. to the credit of the Depreciation Reserve Fund, commencing on December 1, 1988, and each December 1 thereafter, 100 percent of the Depreciation Reserve Fund requirement as defined by the bond resolution; and
- F. to the credit of any other fund or account created pursuant to an applicable Series Resolution.

Funds held by the Treasurer and restricted by bond agreements consist of the following as of June 30, 2006:

Assets	
Construction Fund – Pooled *	\$ 458,808
Bond Sinking Fund – 1998B	2,160
Bond Sinking Fund – 1999A	13,777
Depreciation Reserve	244,615,486
Bond Sinking Fund – 2003B (Construction Fund)	1,456,509
Bond Sinking Fund – 2006 (Construction Fund)	<u>14,970,711</u>
Total assets	<u>\$261,517,451</u>

*The Medical Center also participates in the Commonwealth's Public Higher Education Financing Program, Series 1999A ("Pooled Bond Program"). The indenture of the series specifies the Bank of New York as trustee and the Medical Center is required to make debt service payments to the trustee in the amount billed by the trustee semi-annually.

7. ACCOUNTS PAYABLE

As of June 30, 2006, the components of accounts payable and accrued expenses consist of the following:

Vendor accounts payable	\$22,892,265
Accrued leave	22,992,231
Accrued allotments	14,706,840
Accrued payroll	10,348,450
Other accounts payable	9,826,461
Due to the University	295,872
Other accrued expenses	<u>15,035,085</u>
Total accounts payable and accrued expenses	<u>\$96,097,204</u>

8. LONG-TERM DEBT

Description	Interest Rate	Maturity	Beginning Balance	Additions	Reductions	Refinance	Ending Balance	Current Portion
Bonds payable								
Series 1998B	3.5-5.00	2018	\$ 4,990	\$ -	\$ 290	\$ -	\$ 4,700	\$ 305
Series 1999A	4.5-5.25	2013	32,595	-	4,435	-	28,160	4,660
Series 1999A pooled	4.5-5.25	2019	935	-	170	-	765	180
Series 1999A pooled refinance	4.5-5.25	2020	2,970	-	35	-	2,935	10
Series 2003A pooled	4.5-6.00	2015	31,725	-	345	-	31,380	360
Series 2003B pooled	4.7-6.00	2023	35,917	-	1,307	-	34,610	1,369
UVA pooled debt	4.7-6.00	2024	16,899	-	694	-	16,205	727
UVA commercial paper	4.7-6.00	N/A	4,100	-	-	4,100	-	-
Series 2006 pooled	4.5-6.00	2027	-	36,864	-	-	36,864	-
Total bonds payable			<u>130,131</u>	<u>36,864</u>	<u>7,276</u>	<u>4,100</u>	<u>155,619</u>	<u>7,611</u>
Notes payable								
Helicopter			976	-	976	-	-	-
UVA imaging			<u>2,721</u>	<u>84</u>	<u>778</u>	<u>-</u>	<u>2,027</u>	<u>654</u>
Total notes payable			<u>3,697</u>	<u>84</u>	<u>1,754</u>	<u>-</u>	<u>2,027</u>	<u>654</u>
Total long-term debt			<u>\$133,828</u>	<u>\$36,948</u>	<u>\$9,030</u>	<u>\$4,100</u>	<u>\$157,646</u>	<u>\$8,265</u>

*In thousands

Future Debt Requirements

Fiscal Year	Principal	Interest	Total
2007	\$ 8,265,292	\$ 5,750,264	\$ 14,015,556
2008	9,125,868	7,129,404	16,255,272
2009	10,279,798	6,685,225	16,965,023
2010	10,791,275	6,198,012	16,989,287
2011	10,640,661	5,686,051	16,326,712
2012-2016	54,804,744	19,873,606	74,678,350
2017-2021	28,737,922	9,706,723	38,444,645
2022-2024	<u>25,000,647</u>	<u>3,281,478</u>	<u>28,282,125</u>
Total	<u>\$157,646,207</u>	<u>\$64,310,763</u>	<u>\$221,956,970</u>

During the fiscal year ended June 30, 2006, the Commonwealth, on behalf of the University, issued bonds to the Medical Center for \$36,864,184 for the Hospital Expansion Project. The bonds repaid amounts previously borrowed from the University's Pooled Bond Program.

9. FINANCING OF MAJOR CONSTRUCTION AND RENOVATION PROJECTS

Two major construction and renovation projects were initiated in fiscal year 2003. The first project is expected to cost \$95.2 million and includes an addition to the south side of the University Hospital that will add 120,000 square feet and the renovation of an existing 150,000 square feet on the first and second floors in that building. This project was undertaken to expand and improve facilities for Heart, Perioperative, and Interventional Radiology services. Included in the project are an addition of five operating rooms and the complete reconstruction of 19 existing operating rooms; expansion and reconstruction of Heart Center diagnostic, interventional, and clinic facilities; relocation and expansion of Interventional Radiology; and the reorganization and modernization of hospital based clinical laboratory functions. The addition was completed in July 2004 and the remainder of the renovations should be completed by June 2007. The cost of the project is being financed by a loan from the University's Pooled Bond Program through which the University has issued bonds and made cash available to various University entities to finance construction projects. Amounts previously borrowed in fiscal year 2003 will be repaid over a 20-year period that began June 1, 2004. The funds required to complete the remainder of the project were borrowed from the University in the fall of 2005.

The second project increases and expands the facilities available for Cancer Services. Included in this project is the expansion and relocation of breast care services, construction of a new Infusion Center in the west wing of the Hospital West Complex, and the expansion of examination rooms and other support space. The cost of this project is expected to be \$5 million and was borrowed from the University's Pooled Bond Program.

A third project was initiated during fiscal year 2004. The Clinical Office Building at Fontaine Research Park was purchased in April 2004. The Medical Center borrowed \$17.6 million from the University's Pooled Bond Program to buy the building and complete its construction. The purpose of this building is to expand the outpatient clinic services for the Medical Center.

10. NET PATIENT SERVICE REVENUE

The Medical Center's patient service revenue is as follows for the year ended June 30, 2006:

Gross patient service revenue	
Inpatient	
Routine services	\$ 224,635,405
Ancillary services	755,029,836
Outpatient	
Ancillary services	657,891,936
Clinics	<u>31,813,547</u>
Total gross patient service revenue	1,669,370,724
Allowances for indigent care and	
contractual adjustments	<u>(849,869,684)</u>
Net patient service revenue	<u>\$ 819,501,040</u>

The Medical Center received \$79,811,283 in fiscal year 2006 from the Commonwealth's Department of Medical Assistance Services. Of this amount, \$23,718,115 was the payment of disproportionate share relating to the care provided to indigent patients. The remaining \$56,093,168 was a payment to reimburse the Medical Center for indirect medical education. These payments are included in net patient service revenue as an adjustment to allowances for indigent care and contractual adjustments.

Of the payment received for disproportionate share, relating to the care provided to indigent patients, \$9,035,407 was transferred to physician researchers for related physician services and is included in the purchased services expense.

The amounts written off for indigent care, net of the disproportionate share and indirect medical education payments, were \$16,470,123 for the year ended June 30, 2006.

11. UNIVERSITY ALLOCATIONS

The School of Medicine faculty assists the Medical Center in its mission of providing healthcare and medical education. A survey is conducted annually to determine the value of this effort. An allocation is made on the Statement of Revenues, Expenses, and Changes in Net Assets to reflect the value of this effort as income. This allocation is offset in the operating expenses by an equal amount in purchased services. The amount of this allocation for the year ended June 30, 2006 was \$14,329,604.

Likewise, the University provides the Medical Center with various general and administrative support services. An analysis is prepared annually to determine the cost of providing these services. The same type of allocation as above is made to the Statement of Revenues, Expenses, and Changes in Net Assets to reflect the difference between the direct charge to the Medical Center and the actual cost of these services. The amount of this allocation for the year ended June 30, 2006 was \$1,707,083.

Although these allocations have no direct effect on operating income, they do affect the Medical Center's reimbursement from third-party payers by increasing allowable costs.

12. GAIN SHARING WITH THE SCHOOL OF MEDICINE

Beginning with fiscal year 2003, the Medical Center and the School of Medicine entered into a Memorandum of Understanding for gain sharing. The amount of gain sharing with the School of Medicine is a tiered arrangement based on the Medical Center's income in excess of minimum requirements established by the Board of Visitors. As a result of the Medical Center not exceeding the minimum requirements established by the Board of Visitors, for fiscal year 2006, no gain sharing amount is required.

13. COMMITMENTS

Future minimum lease payments by year and in the aggregate under operating leases are:

<u>Year Ending June 30,</u>	<u>Operating Leases</u>
2007	\$ 8,375,493
2008	3,476,191
2009	2,248,068
2010	2,119,750
2011	554,082
2012-2016	1,870,678
2017-2021	823,200
2022-2026	823,200
2027-2031	823,200
2032-2036	823,200
2037-2041	823,200
2042-2046	823,200
2047-2050	<u>493,920</u>
Total	<u>\$24,077,381</u>

The total rental expense for operating leases for the year ended June 30, 2006, was \$7,876,476.

The Medical Center was party to construction contracts and commitments for the year ended June 30, 2006 totaling \$108,465,620 of which \$88,705,052 was incurred as of June 30, 2006.

14. UNIVERSITY OF VIRGINIA HEALTH SERVICES FOUNDATION

The University of Virginia Health Services Foundation (HSF), a nonprofit educational, scientific, and charitable organization, began operating with the approval of the Board of Visitors as of June 30, 1980, to assist the University in providing hospital and medical care services, medical education programs, and programs of public charity at the University.

On August 1, 2000, management of 63 outpatient clinics operated by HSF since July 1, 1994, transferred to the Medical Center. At that time, the Medical Center filed for provider-based status with the federal government and became responsible for all costs associated with the operations of these provider-based clinics except for physicians' costs. On August 1, 2000, the Medical Center entered into leased employment agreements with HSF for limited personnel who remained HSF employees, but were performing Medical Center duties.

The Medical Center recorded \$14,268,404 as expense payable to the Foundation for the provision of supervisory and administrative services, \$18,056,610 for other services, and \$1,581,268 for rental of space for the year ended June 30, 2006.

The Medical Center recorded income from the Foundation of \$9,289,667 for clinic facility fees and other services, and \$15,426 for the rental of space for clinics for the year ended June 30, 2006.

15. RISK MANAGEMENT AND SELF-INSURANCE

The Medical Center is a participant in the Commonwealth's self-insurance program administered by the Department of Treasury Division of Risk Management. Participation in this program provides the Medical Center with medical malpractice insurance on an occurrence basis with no aggregate limitation and with such limits of coverage equal to the statutory malpractice recovery limits as specified in Section 8.01-581.15 of the Code of Virginia. In the opinion of management, such coverage is adequate to provide for the ultimate liability, if any, which might result from the settlement of claims currently asserted against the Medical Center, as well as the potential liability for medical incidents of which the Medical Center has knowledge, but for which claims have not yet been asserted against the Medical Center. Accordingly, no provision is included in the financial statements for such potential liabilities.

Sufficient information has not been developed by the Medical Center to provide a reasonable basis for estimation of the potential liability for incurred medical incidents, which have not been reported to the Medical Center; however, in the opinion of management, any potential liability for unreported medical incidents is not expected to have a material effect on the financial position of the Medical Center.

The University sponsors a self-funded, comprehensive program of medical care benefits. The program covers all employees of the University and the Medical Center. Fringe benefit expenses include estimates for claims that have been incurred, but not reported. Additional information regarding the medical benefits program is available for the entire University only in the University's annual President's Report.

University employees are covered by a self-insured workers' compensation benefits program administered by the Commonwealth's Department of Human Resources. Information regarding this plan is available at the statewide level only in the CAFR.

Other risk management insurance plans are administered by the Commonwealth's Department of Treasury, Division of Risk Management. Risk management insurance includes property, boiler and machinery, crime, employee dishonesty bond, general (tort) liability, professional liability, aviation and watercraft, and automobile liability. Detailed information relating to this policy is available at the statewide level only in the CAFR.

The University is self-insured for the first \$100,000 of each property and boiler and machinery loss, and for the first \$20,000 of each vehicle physical damage loss. The University also maintains excess crime/employee dishonesty insurance and insurance for vehicle physical damage insurance on vehicles valued in excess of \$20,000.

16. RETIREMENT PLANS

Employees of the Medical Center are employees of the Commonwealth. Substantially all full-time classified salaried employees participate in a defined benefit pension plan administered by the Virginia Retirement System (VRS). Information relating to this plan is available at the statewide level only in the CAFR. The Commonwealth, not the Medical Center has overall responsibility for contributions to this plan.

Substantially, all full-time faculty, including certain administrative staff and health care professionals, participate in Faculty Optional Retirement Plans. These are fixed-contribution plans where the retirement benefits received are based upon the employer and employee contributions (all of which are paid by the Medical Center), and the interest and dividends. Individual contracts issued under the plans for full-time faculty, including certain administrative staff, provide for full and immediate vesting of both the Medical Center's and the participant's contributions. Health Care Professional's employer contributions fully vest after one year of employment.

Total pension costs under the plans were \$9,837,663 for the year ended June 30, 2006. Contributions to the Optional Retirement Plans were calculated using base salaries of \$155,416,215 for the year ended June 30, 2006. The contribution percentage amounted to seven percent for the year ended June 30, 2006.

17. POST-EMPLOYMENT BENEFITS OTHER THAN PENSION BENEFITS

The Commonwealth participates in the VRS-administered statewide group life insurance program that provides post-employment life insurance benefits to eligible retired and terminated employees. The Medical Center also provides retiree life insurance to certain retirees.

The Commonwealth provides healthcare credits against the monthly health insurance premiums of its retirees who have at least 15 years of state service and participate in the state health plan. Additionally, some employees receive healthcare credits for participation in the University of Virginia Health Plan. Information related to these plans is available at the statewide level in the CAFR.

18. OIG DISPROPORTIONATE SHARE PAYMENT REVIEW

In May 2003, the U.S. Department of Health and Human Services' Office of the Inspector General (OIG) issued a report entitled, "Review of Medicaid Disproportionate Share Hospital Payments Made by Virginia's Department of Medical Assistance Services to the University of Virginia Medical Center for Fiscal Years Ending June 30, 1997 and June 30, 1998." The objectives of the review were to determine if disproportionate share hospital (DSH) payments made to the Medical Center for fiscal years 1997 and 1998 (1) were calculated in accordance with the approved state plan; and (2) did not exceed the uncompensated care costs (UCC) as mandated by the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993). While finding that the Medical Center had calculated DSH in accordance with the state plan, the report concluded that the Medical Center overstated its UCC by including UCC for services furnished by the Medical Center's faculty physicians to Medical Center patients (faculty UCC).

On September 8, 2005, CMS issued a notice to Virginia's Department of Medical Assistance Services (DMAS) disallowing with respect to the Medical Center \$4,760,385, which is the federal government's payment to DMAS for faculty UCC at the Medical Center for 1997 and 1998. In its notice of disallowance, CMS stated its interpretation that neither the state plan nor the federal Medicaid statute permits inclusion of faculty UCC in a hospital's UCC. DMAS has appealed this disallowance and any repayment has been stayed pending the appeal. DMAS and CMS have submitted their appellate briefs to the Departmental Appeals Board (DAB) in the United States Department of Health and Human Services. The parties are waiting to hear whether DAB will hold oral argument or make a decision based on the briefs only. Counsel for DAB has indicated that in either event the earliest a decision is likely is December 2006.

CMS has obtained from DMAS information showing that inclusion of faculty UCC for the years 1999-2005 in calculating Medicaid DSH payments to the Medical Center affects \$1,231,842 in the federal share of Medicaid DSH payments to the Medical Center for 1999. The financial impact of the final resolution of this case on the Medical Center is not known at this time; however, based on the CMS disallowance for 1997 and 1998 and the data furnished by DMAS for 1999-2005, management has recorded adequate reserves for the potential recovery by CMS, should the appeal be decided in favor of CMS and DMAS recovers the federal payments at issue from the Medical Center.



Commonwealth of Virginia

Walter J. Kucharski, Auditor

Auditor of Public Accounts
P.O. Box 1295
Richmond, Virginia 23218

November 10, 2006

The Honorable Timothy M. Kaine
Governor of Virginia

The Honorable Thomas K. Norment, Jr.
Chairman, Joint Legislative Audit
and Review Commission

Board of Visitors
University of Virginia

INDEPENDENT AUDITOR'S REPORT ON FINANCIAL STATEMENTS

We have audited the accompanying basic financial statements of the **University of Virginia Medical Center**, a division of the University of Virginia, as of and for the year ended June 30, 2006, as listed in the Table of Contents. These financial statements are the responsibility of the Medical Center's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, based on our audit, the financial statements referred to above present fairly, in all material respects, the financial position of the University of Virginia Medical Center as of June 30, 2006, and the changes in its net assets and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis presented on pages 1 through 9 is not a required part of the basic financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplemental information. However, we did not audit the information and express no opinion on it.

In accordance with Government Auditing Standards, we have also issued our report dated November 10, 2006, on our consideration of the University of Virginia's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. This report on the total operations of the University of Virginia for the year ended June 30, 2006, includes our consideration of the operations of the University of Virginia Medical Center. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be considered in assessing the results of our audit.

AUDITOR OF PUBLIC ACCOUNTS

JHS/sks
sks: 60

UNIVERSITY OF VIRGINIA MEDICAL CENTER

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